

# The Interface of Trade, Investment, and Competition Policies

## Issues and Challenges for Latin America

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Latin American countries must try to adopt competition policies that enhance gains from trade reform and raise the returns on investment.



## Summary findings

Latin American countries have not had much experience with competition policy. Restricted trade policies, together with no competition policy, have often resulted in domestic monopolies.

Trade liberalization in the 1980s and 1990s has strengthened import competition, but trade policies alone cannot create a competitive economic environment. And trade policy as an instrument of competition policy (limited as it has been) has been constrained by a disproportionate amount of nontraded goods, vertical integration, and distribution monopolies — and sometimes the use of antidumping, countervailing, and safeguard measures.

Competition policies — such as antitrust laws, merger controls, and other regulatory measures — can prevent exclusionary practices, collusion among competitors, and the abuse of market power. Allowing foreign ownership and liberalized investment regimes will further enhance domestic competition by adding market presence.

Guasch and Rajapatirana contend that trade and competition policies must complement each other and that when they do, welfare improves. Tensions between the two policy areas arise because of globalization, regional policies, technical barriers, certain kinds of industrial policy, and macroeconomic exigencies.

Trade policy itself can be used for protection even without high tariffs or quantitative restrictions. Antidumping, countervailing, and safeguard measures limit rather than promote competition. These measures — which should be GATT-compatible by law and competition-promoting in spirit — must be used judiciously. Guasch and Rajapatirana favor the use of safeguards rather than other measures to provide temporary protection for firms facing import surges.

Latin American countries have recently made impressive strides in trade reform, but have made limited use of competition policies. Guasch and Rajapatirana argue for more use of competition policies to enhance gains from trade reform. They also argue for harmonization of competition policies as these countries reduce barriers against each other through regional agreements.

More efforts should be made to:

- Create favorable competitive environments.
- Harmonize trade, regulatory, and competition policies as well as conflict resolution mechanisms.
- Strengthen enforcement mechanisms and make them binding.

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# **The Interface of Trade, Investment, and Competition Policies: Issues and Challenges for Latin America.**

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## 1. *Introduction*

The 1980s and the 1990s have seen impressive reforms in trade policies, followed by even more recent attempts to introduce, reform, and refine competition policies in Latin America. The motivation for the trade reforms arose from the poor results of earlier policies, the findings of research on trade and development, and the experience of East Asian countries which demonstrated the success that could be had from trade liberalization.<sup>1</sup> In addition, the large external shocks and investment booms of the 1970s and 1980s exacerbated the macroeconomic disequilibrium further necessitating adjustment. As a part of the World Bank's adjustment package for these countries trade reforms were included in the structural adjustment loans extended by the Bank. Stabilization aspects were handled by the stand-by facilities provided by the International Monetary Fund, which also supported trade and exchange rate reforms. Consequently, the Latin American and Caribbean countries have become highly open trade regimes (see Table 1).

As for competition policies, there was hardly any effort to introduce them, let alone refine, even in some perfunctory manner, those in existence. Nearly all the Latin American countries had highly restricted trade regimes with little or no import competition. Under these circumstances, and since the prevailing ideology of inward oriented policies implied state ownership of many of the activities, some competition policies were needed to substitute for the absence of import competition. Where there was no state monopoly there were private monopolies. They were regulated not so much by competition policy, but rather by price controls, capacity licensing, and the implicit barriers to entry arising from import and exchange controls. In this situation import restrictions and the lack of competitive policies reinforced each other to lead to non-competitive, moribund, and high cost domestic industries.

To be sure, there were earlier episodes of import competition that arose not as a microeconomic efficiency device, but as a supply management instrument. These occurred when countries found themselves with high reserves due to terms of trade improvements, good weather that raised export crops, or strong fiscal corrections that led to periods of high foreign exchange reserves. In other words, import competition was allowed for limited periods and more as a result of macroeconomic policies, rather than as an instrument to achieve greater efficiency or growth by actually encouraging competition.

With this background the paper begins by examining the role of trade and competition policies in the Latin American region, with specific country references as warranted. The next section discusses trade, competition, and investment policies with respect to their conceptual aspects

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<sup>1</sup>The work of Little, Scitovsky, and Scott (1970); Bhagwati (1978); and Krueger (1978); are outstanding examples of research into trade and development that influenced trade reforms.

Table 1: Some Indicators of Trade Regimes before and after Reform

Country	Pre-reform / Post-reform year		Average unweighted legal tariff rates		Tariff range legal tariff weight		Coverage of QRs on imports		Openness of economy	
			pre-reform	post-reform	pre-reform	post-reform	pre-reform	post-reform	pre-reform	post-reform
Argentina	1987	1991	42 <sup>a</sup>	15	15-115 <sup>a</sup>	5-22	62 <sup>a</sup>	Few	38.6	54.3
Bolivia	1985	1991	12 <sup>a</sup>	8	NA	5-10	NA	Minimal	57.5	83.9
Brazil	1987	1992	51	21	0-105	0-65	39	Minimal	21.2	25.2
Chile	1984	1991	35	11	35	11	Minimal	0	44.9	56.3
Colombia	1984	1992	61	12	0-220	5-20	99	1	28.2	32.7
Costa Rica	1985	1992	53 <sup>a</sup>	15 <sup>a</sup>	0-1,400 <sup>a</sup>	5-20	NA	0	58.7	79.0
Ecuador	1989	1992	37 <sup>a</sup>	18	0-338 <sup>a</sup>	2-25 <sup>d</sup>	100	0	48.7	50.8
Guatemala	1985	1992	50 <sup>a</sup>	15 <sup>a</sup>	5-90	5-20	6 <sup>a</sup>	0 <sup>a</sup>	31.3	35.6
Honduras	1985	1992	41 <sup>a</sup>	15 <sup>a, f</sup>	5-90	5-20	NA	0	62.8	61.8
Jamaica	1981	1991	NA	20	NA	0-45	NA	0 <sup>a</sup>	105.5	163.5
Mexico	1985	1990	24 <sup>b</sup>	13 <sup>b</sup>	0-100	0-20	92 <sup>b</sup>	20 <sup>b</sup>	22.6	34.3
Paraguay	1988	1991	NA	16	NA	3-86	NA	Few	51.0	63.1
Peru	1988	1992	NA	17	0-120	5-25	100	0 <sup>a</sup>	30.4	41.6
Trinidad and Tobago	1989	1991	NA	41 <sup>a</sup>	NA	0-103 <sup>a</sup>	NA	Few <sup>d</sup>	124.9	141.2
Uruguay	1987	1992	32	18	10-55	12-24	0	0	38.0	45.1
Venezuela	1989	1991	37	19	0-135	0-50	40	10 <sup>j</sup>	49.3	54.3

a. Including tariff surcharges.

b. Percentage of domestic product.

c. Import weighted average tariff.

d. Ecuador also has a specific tariff of 40 percent on automobiles.

e. Percentage of domestic product, Guatemala has significant QRs for health and safety reasons; pre-reform they covered 29 percent of domestic manufacturing production.

f. Including tariff surcharges.

g. Some QRs exist for health and safety reasons.

h. Production weighted average.

i. Agricultural products only.

j. Another 8 percent of tariff items are restricted because of health reasons, pre-reform the number was 5 percent.

Source: World Bank (various reports, staff estimates and ANDREX data).

and instruments. The third section discusses the complementarity and the likely tensions between trade competition policies and investment regimes and their limits for achieving efficiency and growth. The fourth section examines the implications of anti-dumping safeguards and countervailing measures with respect to competition promotion. The fifth section discusses issues relating to the risks and consequences of anti-dumping, countervailing, and safeguard measures. The sixth section discusses challenges to the harmonization of policies. The final section provides conclusions.

## **2. *Trade, Competition, and Foreign Investment Policies: Concepts and Instruments***

### **Trade Policy**

Trade policies are those which are aimed at altering the relative price of goods traded through tariffs, subsidies, quotas, safeguards, and anti-dumping and countervailing duties. The essential feature of all these measures when used as instruments of trade policy is that they drive wedges between the foreign and domestic price of a good or service at a given exchange rate.

Trade policy per se covers a wide area. It includes both the export and import regimes as well as the institutional framework in which trade policies are implemented. Today, trade policy goes beyond goods to services, and includes trade in financial assets as well as exchange rate policies. The lines of demarcation between trade and a host of other policies have become increasingly blurred. Trade policies have become more related to investment measures, intellectual property rights, environmental standards as well as labor standards.

### ***Export Promotion Policies***

In the past these policies had played an important role precisely because Latin American countries were reluctant to liberalize their import regimes and to replace various export promotion measures with exchange rate adjustments. This was the main reason why specific export promotion measures were implemented. Export promotion policies lie at the heart of external competition in third markets. Consequently, countries attempted to reduce the bias against exports caused by overvalued exchange rates, import protection measures, and particularly from import measures which effected imported intermediate inputs used in the production of exports. The various export promotion measures included duty drawbacks and special exchange rates as well as concessional credit for exports.

### ***Protection from Imports***

Import protection was a principal reason for the development of domestic monopolies. While tariffs raised foreign prices, it was quantitative restrictions (QRs) that bestowed monopoly power to many import substitution industries. Within a regime of quantitative restrictions competition was limited, particularly when import licenses were granted on the basis of existing capacity and with limited access to foreign exchange.

Other measures have had a protectionist character including voluntary export restrictions (VERs), anti-dumping, safeguards, and countervailing duties. The first of these measures attempt to restrict imports by co-opting the exporters under the threat of open protection. The exporting country is asked to "volunteer" to reduce exports of the item in question. The VER between the United States and Japan for automobiles is the best known example of this.

Anti-dumping, safeguards, and countervailing duties have recognized functions in the GATT rules. But they can, and do, become protectionist devices when their purpose exceeds what has been stipulated in international law as acceptable codes of conduct to prevent predatory pricing, sudden surges in imports that cannot be readily absorbed and as a measure against government subsidization by the exporting countries.

The relationship between trade policies and competition policies is best seen in the area of import competition. Trade policies, such as VER, quotas, high and extremely differentiated tariff rates, anti-dumping duties, and burdensome bureaucratic procedures, tend to protect domestic import competitors increasing their producer surplus while consumer surplus declines with the higher prices and lower outputs. The improper setting of any of those instruments as a part of a trade policy framework adversely impacts competition and efficiency. Import restrictions not only constitute a barrier to competition, but can also act as a brake to structural change in developing economies. As Bhagwati (1965) has noted, quantity restrictions can have anti-competitive effects. Krishna (1984) confirms the anti-competitive nature of quotas in oligopolistic markets, whereas Messerlin (1990) has argued that anti-dumping policy encourages importers and domestic competitors to cooperatively develop anti-competitive price-raising agreements.<sup>2</sup> Protection may also lead to inefficient entry. Competition from imports improves resource allocation and use, and prevents the abuse of market power by domestic firms.

### **Competition Policy**

The term competition policy encompasses the area commonly known as anti-trust or anti-monopoly law and practice as well as various micro-industrial policies affecting markets. Competition laws strive to deter and prevent abuses of market power, dominance, exclusionary practices and the reaching of agreements among competitors. They aim to promote and protect competition and economic efficiency, rather than competitors.

Market power is dependent on the relative size and structure of the market (e.g., number of competitors, ease of entry, contestability extent, trade barriers, and availability of present or potential substitutes). Dominance is based upon the absolute size of the producing firm, its links to inputs and other output producing industries, and its influence in and by the international market.

Competition policy is executed through the legal system, and works through its proper and predictable enforcement-deterrence effects. Competition laws essentially address two

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<sup>2</sup>The EC market provides the best evidence for this collusion outcome of anti-dumping measures.



areas: the conduct of business and the structure of economic markets. Issues of performance are embedded directly or indirectly in those two areas. In the event of transgressions, producers are subject to criminal and civil prosecution, fines, or injunctions.

**Conduct Policies.** Competition policy prohibits conduct that either unfairly diminishes trade, reduces competition, or abuses a market-dominating position. The laws are intended to counter:

- ***Horizontal restraints:*** These are unilateral or collective actions weakening or restraining competition among firms in the same market. Examples of this are: price or bid fixing (competitors explicitly cooperate to set prices, or to prearrange auctions outcomes); conscious parallelism (tacit agreement on price setting; it may occur in competitive markets as well as in oligopolistic ones, so it is considered only a symptom of non-competitive behavior); output restraints; market division (suppliers self-allocating customers among themselves); exclusionary practices; exchange of commercially sensitive information; predation; or restraints on entry.
- ***Vertical restraints:*** These are provisions in contracts between suppliers and their distributors (and retailers). Vertical restraints may be used to support non-competitive conduct by competing suppliers, the exercise of market power by distributors, or the segmentation of markets on a geographic basis to practice geographic price discrimination. Examples are: exclusive dealing (suppliers disallowing purchase of competitors' products); refusal to deal; resale price mechanism (supplier conditions sale to distributor on establishing distributors' price); territorial restraint (selling in limited region to support price discrimination); price discrimination; premium offers, tying; and full line forcing (supplier requiring distributor to carry all supplier's products).
- ***Enforcement standards:*** The existence of laws is necessary, but not sufficient, to achieve the objectives of competition policy. Enforcement depends upon attributes of the legal system and the judiciary, as well as the credibility and sanctity to which the laws are upheld.

**Structural Policies.** These have become the fastest growing means of pursuing anti-trust aims. Competition laws influence market structure by affecting intercorporate transactions (contractual or ownership relationships among suppliers or competitors), usually mergers, takeovers, joint ventures, and asset transfers. They aim to prevent transactions that would reduce the independence of competing suppliers (vertical integration) and increase concentration in market (horizontal integration);

- ***Merger control regulation:*** Selectively prohibiting mergers that would substantially increase concentration in the market or restrain trade among suppliers.

- ***Pre-merger notification:*** Allows authorities to review proposed mergers prior to actualization, thereby making merger control administration more efficient.
- ***Enforcement and remedial measures under merger control:*** Since transactions involving multi-product firms might lead to competitive concerns over only a few products, remedial measures such as divestiture and de-monopolization have been introduced. These remedies have been designed to promote competition by breaking up a supplier into smaller independent units, thus preventing the negative increased concentration effects of the merger. This can effectively replace regulatory supervision of economic conduct with market discipline in some contexts.

### **Performance Policies**

- ***Administrative pricing by anti-trust authority:*** The state compensates for lack of competition by dictating prices or output. Although available, these policies are rarely used as they counter the fundamental premise that markets are more efficient at determining prices and outputs. The standard policy is regulation of various modes and, usually, is only applied to sectors that display significant natural monopoly characteristics.

### **Direct Foreign Investment and Ownership Restrictions**

An important complement to trade policy and an element of the import competition framework is the foreign investment and ownership regime. While import competition (free trade) provides for market access, foreign investment and ownership provides for market presence (foreign-owned domestic production). Both increase competition. Direct market participation from foreign entities can be a powerful competition device. It adds heterogeneity, brings newer technologies and vision, and it limits domestic advantages based on transportation and border related transaction costs and non-tradable factors. Moreover, direct foreign investment allows the home country to retain most of the benefits of trade liberalization. Most countries have some restrictions, global and sectoral (banking, automobiles and oil are some examples), and other trade related investment restriction measures (local content) for foreign participation, often not for economic reasons. Clear legislation, opening the domestic market to foreign participation, recovery of foreign investment, and the absence of ownership restrictions, are all essential for an effective competition policy. Similar arguments apply for the access of foreign entities to domestic procurement processes. An important corollary to foreign direct investment and ownership law are laws relating to intellectual property. The legal framework must protect the rights of inventors, artists, and patent holders and reward innovation and artistic talent. In the absence of such protection fewer goods and services will be produced and society will be the loser. At the same time the consumer must also be protected to prevent the emergence of perpetual unchallenged monopolies that vitiate competition policies.

The enactment of effective intellectual property legislation and its proper enforcement is also key for increased competitiveness in domestic markets. It is essential to secure technology transfers and the licensing of new technologies which improve competitiveness and efficiency. Its objective is to facilitate the development of technological infrastructure and access to, and transfer of, foreign technology and to foster innovations. Partial evidence of the need for such legislation and for its proper enforcement comes from a recent survey of large US chemical, pharmaceutical, and technology companies. Over 70% of these firms stated that intellectual property protection in most LAC countries is so weak that they would not grant companies in such countries licenses for the use of their products or of their most recent technologies.

As of now, intellectual property rights are inconsistently protected from country to country. There is a need to homogenize and simplify procedures for international protection of patents, trademarks, copyrights, designs, and trade secrets (treaties such as the European Patent Office and the proposed Madrid Convention Protocol). Enforcement should fall under the auspices of a supranational body, rather than relying on voluntary, or bilateral means. As of now, The Uruguay Round includes a provision for Trade Related Intellectual Property Rights (TRIPS). As with the rest of the Round, the substantive negotiations and signing have taken place but a certain amount of work is still needed to tie up the legal issues. Furthermore, there are transitional provisions which give developing countries some additional time, up to ten years, before they have to meet their obligations. TRIPS will not be applicable until the World Trade Organization (WTO) is established. The TRIPS agreement essentially requires that each signatory accord nationals of other member states no less favorable treatment than it accords to its nationals. It provides the type of minimum protection already set out in the Paris Convention, Berne Convention, and other intellectual property agreements. In the longer term, referral of disputes will be to the WTO, but not until five years after its establishment.

### **3. *Trade and Competition Policies: Complementarities and Tensions***

#### **Analytical Framework**

The easiest way to see the complementarity between trade policy and competition policy is to consider the traditional neo-classical model of trade, with two goods, community utility functions, and welfare maximization with a fixed aggregative factor of production. (See Appendix figure A.) When there is free trade, and the country in question has no monopoly power in the tradeable sector, welfare can be maximized by equating the domestic marginal rates of transformation in production with the foreign marginal rate of transformation and exchange, which is given by the fixed terms of trade. When some non-traded goods are produced they are not subject to foreign competition. In that case the level of welfare achieved with free trade and no competition policies is lower than that which could be achieved with competition policies. That is, competition policies allow the economy's domestic marginal rates of substitution in production to be equated with foreign marginal rates of transformation by inducing domestic firms to reduce monopoly elements in the production of non-tradeables.

Under restricted trade (one extreme case is autarchy), domestic marginal rates of transformation in production will differ from the foreign marginal rate of transformation of production due to the lack of import competition (See Appendix figure B). Part of this could be remedied by competition policies. But only by accident can the domestic marginal rate of transformation be equal to the foreign marginal rate of transformation under restricted trade. The worst case is when there is restricted trade and reduced import competition and no competition policies as there will be monopoly elements created by import barriers. This could convert an important part of the economy into non-tradeables with limited competition and no corrective policies to prevent the emergence of monopolies. Thus, a welfare ranking can be established for the simple neo-classical model of trade (See the Appendix). Free trade with competition policy leads to the highest possible welfare. Free trade alone will lead to a lower level of welfare compared to the highest level. Restricted trade with competition policy could be less superior than free trade with no competition case especially in small economies where free trade is a powerful competition instrument. Restricted trade with no competition policy is the worst of the four possible combinations of free trade and competition. Thus, there is a theoretical case of complementarity between trade and competition policies.

Of course, the presence of economies of scale and externalities make the neo-classical case somewhat limited. The presence of economies of scale and externalities give rise to at least a temporary case for departures from the pure competition case. This is at the nub of strategic trade theory. At the same time there are risks in attempting to fine tune trade and competition policy because of another development of economic theory, namely public choice theory. This points to the possible capture of policy making by interested parties and the danger that public servants, whose behavior cannot be monitored, will engage in rent seeking. In this sense the welfare level achieved with restricted trade and no competition policy is still relevant as it would lead to lower levels of welfare.

From a normative standpoint trade and competition policy share the common economic objective of attempting to remove barriers to the competitive process and thus ensuring market access and presence. These increase efficiency. Overall, both policies can reinforce each other as seen in the theoretical framework. In practice, however, when other objectives are introduced, as described below, there could be considerable friction in the trade, competition, and investment nexus.

Competition policy focuses on the rules of the game over the behavior and actions by market participants, and as such, it tends to be neutral in design as opposed to pro-active. Through its deterrent effects, when the legislation is effectively enforced, increases in competition and a competitive environment can be secured. Trade policies have traditionally focused on facilitating access to markets, so as to increase output and realize the associated benefits, while at the same time maintaining some level of protection for the domestic industries. The arguments supporting protective components have been varied, but most often

they have been based on the need or desire to shelter, presumably temporarily, incipient domestic industries from more advanced and efficient cost-quality foreign competitors, or they are based on pressures from politically influential interest groups. Aside from the infant industry type, the present economic arguments for protection are usually based on the externalities generated by some sectors, particularly on the diffusion of technology and know-how. In practice trade policy tends to be more pro-active, in that it can involve subsidies of one form or another, overt or hidden, that target or favor some domestic sectors or regions and erect barriers to foreign competition (through tariffs or non-tariff instruments). As a result, trade policy can either significantly promote or substantially impede the economic goals of competition policy. At issue then is what is the appropriate mix between trade and competition policies to best foster competition, efficiency, and growth.

There is a natural affinity and opportunity for convergence between trade and competition policies. Trade policies include not only border measures such as import tariffs, export duties and quantitative restrictions, but non-border measures as well. For example, during the Tokyo Round, specification of technical standards, government procurement, and domestic subsidies were included in the negotiations. The Uruguay Round included intellectual property rights, trade related investment measures, and services. This means that the distinction between competition policies and trade policies has become somewhat blurred. Moreover, many of the trade policy instruments are designed to deter anti-competitive practices by foreign firms. For example, if and when properly used, anti-dumping measures counter predatory pricing, and countervailing duties counter subsidies as well as overall unfair competition. Competition policies also aim to deter those practices by domestic firms. The growing extraterritorial application of competition policy further blurs the jurisdiction and distinction between trade and competition policies. The proper extension of the latter could bring into question the conceptual need for some of those trade policy instruments.

Free trade and investment can be a most powerful competition inducing instrument/policy. Import competition is essential where high natural or strategic entry barriers have allowed a few firms to attain and abuse a dominant position. Competition from imports is an effective way of curbing the exercise of market power, particularly when production technology calls for scales typical of natural monopoly, or when one, or a few, dominant local producers are entrenched or protected by high entry barriers (e.g., scale, sunk costs, technology). To be most effective as competition devices imports should be free from all restrictions other than a moderate tariff. Non-tariff barriers should be removed and import procedures should be transparent and not subject to discretionary changes.

The idea that international competition through trade liberalization can act as a substitute for domestic competition stems from Bhagwati (1965), where potential imports, as well as actual imports, disciplined the behavior of the domestic producers. In reality the effects of international competition on domestic competition are insufficient. Trade liberalization by itself is an inadequate substitute for effective competition policy because alone it is unlikely to promote competitive market structures and efficient behavior. This is the basic finding from the framework discussed below. As a result, trade policy and competition policy are better regarded, not as substitutes, but as complementary policies. Among others, the presence of non-tradables is an important reason as to why trade policies

cannot be fully substituted for competition policies. In other words, a firm producing a non-tradable can have monopoly power and dominate an industry.

Thus, the distinction between tradeables and non-tradeables reinforces the importance of the incomplete substitutability between trade policy and competition policy. Trade liberalization and import penetration do not automatically lead to increased competition because restrictions in non-tradeable services can form an invisible barrier to trade. Non-tradeable services, like marketing and product repair, maintenance, and infrastructure are vital for the successful flow of imports and the presence of various regulations and organizational barriers in this area may severely restrict import penetration and thereby require competition policies to address the issues.

In a different perspective, competition policy is needed because liberal trade policies alone cannot enhance competition (by providing a competitive market structure) in non-tradeable services where the imperfect market is local or regional (e.g., retail trade, services, infrastructure facilities, particularly transport). The same argument applies for tradable sectors where transportation and border transaction costs are an important component of the cost of the product.

In the presence of vertical restraints and market foreclosures, foreign producers might not be able to distribute their products. The control of distribution systems can lead to the privatization of tariffs phenomena, where domestic producers capture the "tariff" rents-as markups of foreign goods-and consumers lose the benefits of open trade. The case of Nabisco, when it was considering introducing its products in Colombia, is an example. Faced with foreclosures in the Colombian food distribution system, controlled by the domestic food stuff producers, Nabisco was forced into a joint venture with them and this led to parallel pricing of domestic and foreign goods and a loss of the competitive effect, and the benefits of lower prices to consumers. Similarly, in sectors characterized with network structures (telecommunications, electricity, gas, etc.) often without clear or regulated third party access rules and fees, the effect of import and foreign investment competition will be moot.

Moreover, an effective, through proper enforcement, competition policy acts as (partial) insurance in the event of reversals in the trade regime, be it through the raising of tariffs or the abuse of other trade instruments as anti-dumping and countervailing duties.

Other recent developments that limit competition are rules of origin and local content clauses adopted in free trade agreements. Both discriminate against non-member countries and, as a result, limit market access and presence and thus competition. Moreover, the enforcement of rules of origin and local content clauses has been erratic and differential on sectoral basis, further distorting competition and production in these economies.

### **Limits to Trade-Induced Competition**

Despite the potential benefits of trade liberalization policies, many countries choose, through trade policies, to limit their exposure to foreign competition. The reasons that

countries have eschewed the full potential of trade policy as an instrument of competition are varied. Among them are the following.

(a) Initial conditions vary significantly across countries and sectors: The benefits of free trade are not equally distributed across countries and sectors. The share of trade flows in GDP varies significantly across countries. This might lead to a different sense of urgency amongst countries toward trade liberalization. These objectives would differ according to the size of the country, the alignment of different interest groups, and the exigencies of other priorities. Moreover, within a country, some sectors which are internationally more competitive will gain while other less competitive sectors will lose. If the political influence of the latter sectors is larger than that of the former, trade liberalization is unlikely to occur or at best it will be selective by sector.

(b) Temporal distribution of the effects of trade liberalization may be disruptive: For many developing countries, and often as a result of import substitution policies of the past and other protectionist measures, the initial effect is often the collapse of a number of non-competitive industries and firms and associated job losses. This effect is quite visible and the affected labor and firms are quite vocal and create social and political tensions. On the other hand, the immediate benefits, lower consumer prices and greater selection of products, greater market discipline, and the emergence of traders, are widespread and the individual impact not as significant. This asymmetry-the short term political cycle, might induce governments to slow the pace of trade liberalization and the reaping the benefits associated with competitive discipline. The long term benefits discounted by current interest rates could be positive. Yet, the short term costs may be concentrated in time and in some sectors. In such a case protection would continue and competition remain limited.

(c) Comparative advantages can be acquired: In the hands of policy makers this widely accepted premise can lead to the sheltering of selected sectors from foreign competition until benchmark competitive levels are domestically achieved. Here the focus is on dynamic or long term efficiency rather than static or short term efficiency. However, this strategy can be prone to misuse and can lead to long-lasting protectionist trade policies, either economy wide or for designated sectors.

### **Elements of Tension Among Trade, Investment and Competition Policies**

There are also specific factors that can undoubtedly create tensions among trade, investment, and competition policies. There can be conflicts, as a result of economic, social, or political objectives. Objectives in the design of those policies other than efficiency are included in many countries, but these social and political objectives vary across countries and may often conflict with the target of economic efficiency. Substantive convergence among the objectives of trade, investment, and competition policies must first confront the fact that the overall objectives may vary from country to country as well as initial conditions. As the EC experience illustrates, the root cause appears to be the substantial differences in individual country approaches to regulation stemming from deeply-held national convictions

about the dividing-line between market forces and government intervention. These differences can be heightened when trade policies across trading blocks are considered.<sup>3</sup>

The threat of protectionism, with its ill effects on competition, always looms over the design of trade policies. It is often reflected in industrial and regional policies, government procurement, non-tariff barriers, voluntary exports restraints, subsidies, anti-dumping and countervailing measures, rules-of-origin measures, standard and other regulation setting, as well as approaches to foreign investment and ownership. In particular the following specific factors can be a source of tension between trade, investment, and competition policies:

- **Impact of globalization:** Globalization of production, research, and marketing demands larger-scale activities than is present at the national level. Competition policy based on, or focused at, a national level might impede the development of large firms. But, in order to be competitive at a global level, firms must grow and as a consequence, a small number of domestic firms will control some sectors.
- **Regional policies:** These policies are often intended to redress a series of inter related imbalances in regional development, labor market supply, demand and urban growth. In part, this concern with distribution is derived from equity considerations as much as by the need for economic efficiency. Since they often involved subsidies and other favorable treatment it can lead to "unfair" competition both domestically and in foreign markets.
- **Technical barriers:** This refers to the unilateral setting of product standards and stricter regulations on food, health, and environmentally related products. Different environmental and consumer protection laws are another source of conflict and tension. They are often central issues in the struggle over trade agreements. Also government pacesetting on anti-pollution and public health measures can be particularly vulnerable to challenge as unfair trade barriers under agreements such as GATT. The argument, for example, centers on whether laws and regulations that are stricter or different than international or treaty norms (say GATT or treaty accord), unfairly discriminate against imports. This can usually be defended so long as its environmental and other public safety-related initiatives meet certain tests, including ones based on science. The difficulty is that a scientific defense can be a weak one since the supporting evidence is often inconclusive and can be mobilized to defend opposite view points.<sup>4</sup> There is also the question of the right to set technical barriers as precautionary measures, when the evidence is ambiguous. Two recent cases illustrate the point. One is the recent ruling by a GATT panel that

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<sup>3</sup>Obviously the objectives need not be as described. As an example, it has been reported that when the EC was considering what kind of standards to set for HDTV the overwhelming response appeared to be any standard that would keep the Japanese out of the EC market.

<sup>4</sup> Under the World Trade Organization, following the Uruguay Round, health and sanitary standards are defined less ambiguously. All these standards must be verifiable by an agreed test.



a US ban on imported tuna, caught in a manner that causes excessive dolphin deaths, is illegal. The other, concerns a challenge brought by the European Union to America's "gas guzzler" tax on cars that fail to meet US fuel efficiency standards.

- **Industrial Policies:** This is a major source of conflict. Often the targeting of industrial sectors involves a combination of protection from foreign competition and the granting of subsidies, or favorable domestic treatment, or infant industry treatment. The four instruments of industrial policy are; cheap loans, net transfers, trade protection, and tax relief. The common arguments for an active industrial policy are based on the belief of future high benefits/rents or the capturing of significant externalities—technology and know-how. This is a controversial subject. In addition to some general promotional measures the government picks winners (or losers as the case of Japan illustrates).<sup>5</sup> Also, externalities are often associated not with a particular industrial segment, but with a cluster of productive or informational activities that provide the basis for industrial competitiveness. This is difficult for the government to target. Often governments lack the institutional and administrative capacity to target effectively and the political will to terminate the incentives after a set period. It appears more appropriate to focus on human, technological, and institutional capabilities as a means to shifting comparative advantage.
- **Sectoral Shifts and Restructuring:** Another issue is government intervention to restructure sectors as a result of the impact of sectoral shifts in economic activity, technological developments, and the lifting of protection and other barriers. Often the approach is to link subsidies with capacity cuts. Heavy industry sectors and agriculture are often the affected sectors, (e.g, steel in the EEC). The aid for restructuring enterprises is offered in exchange for capacity cuts. The threat of full closure versus partial closure with government help tends to induce firms cooperation.
- **Macroeconomic Exigencies:** Trade, investment, and competition policies have a broad macroeconomic impact. As a result, there can be pressures for trade policy to yield to the macroeconomic exigencies that arise. In the past trade policies have been used for macroeconomic purposes when the countries tightened import restrictions when confronted with balance of payments difficulties. This was a common approach to dealing with these imbalances. (Little, Cooper, Corden, and Rajapatirana, 1993). For instance, today in Latin America there are examples of exchange rate appreciations arising from capital inflows that have led to pressure on the trade regime for some reversals, even though open trade as a principle has taken root in the continent. Argentina,

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<sup>5</sup> Beason and Weinstein (1994) show that Japanese industrial policy during the period 1955-90 did not pick winners. They show a negative correlation between growth in each sector and the support provided by various industrial policy instruments.

Colombia, and Uruguay have shown certain departures from the earlier regimes, in the form of increases tariffs. Colombia has introduced reference prices for textiles and garments, as well as for eight agricultural goods. In this sense trade policies are particularly dependant on the macroeconomic environment.

- **Government Doctrines:** There are a number of outstanding government doctrines that provide immunity against certain anti-competitive actions or bars suits against governments. For example, in the US there is the "Noerr-Pennington Doctrine" which holds that political activity is immune from antitrust laws. As a result, many actions by foreign trade associations which may have anti-competitive effects are protected on the grounds that they are part of a broader effort to affect government policy. Or the "Act of State Doctrine," which shields actions by foreign governments. This bars suits in which the alleged anti-competitive behavior is by a foreign government rather than a foreign private company.

#### ***4. Anti-dumping, Countervailing, and Safeguard Measures: Issues, Risks, and Consequences***

Anti-dumping and countervailing duties are imposed in response to what governments consider to be 'unfair' trade practices initiated by their trading partners. The former are a reaction to dumping which refer to export sales at prices lower than home market sales, while the latter are a response to subsidies provided by foreign governments to its industries. Dumping is considered an activity of a particular firm or enterprise, whereas subsidies are acts of the foreign government. Although the aims of these measures are to promote international trade on a level playing field, there exists the potential that they will become protectionist and in fact hinder the gains from trade.

Although these policies are theoretically transparent, in practice they are plagued by a host of definitional and measurement issues which impede their effectiveness.

#### **Issues in anti-dumping**

Anti-dumping cases are increasing. GATT records show that during 1985-92 there were 1,148 anti-dumping cases, an average of over 150 cases per year, while there were no more than 12 case per year from 1947-68. Between 1985 and 1992, the United States brought some 300 cases, Australia 282 cases, the European Union 242, Canada 129 cases, Mexico 84, and Brazil 13. The concern is that these measures have become protectionist devices.

Dumping is defined as the sale of products for export at a price less than normal or fair value. Less than fair value pricing arises if: i) foreign firms price discriminate by charging a lower price on sales to foreign markets than on sales to their home market or to third countries; or ii) if foreign firms charge prices on sales to foreign markets that are below cost of production ("constructed value"). The definition has been extended to refer to selling below cost in the export market, even if sales below cost are occurring in the firm's

domestic market as well. A domestic agency has to determine whether a domestic industry is injured by unfair imports. Once dumping has been established and it is confirmed that this causes material injury to the domestic industry (or retards the establishment of a domestic industry), an anti-dumping duty may be imposed on the offending imports.

### *Definition of dumping*

Anti-dumping laws define the practice of dumping in terms of price discrimination. They do not require that predatory intent be demonstrated, and they only demand that injury be shown to a particular industry rather than to competition or welfare in general. In so doing the laws can target what can essentially be rational competitive behavior which does not necessarily decrease (long term) welfare. In consequence, the definition of dumping itself allows for situations in which anti-dumping duties may be inappropriate. First, when dumping is merely an international extension of price discrimination and the foreign exporter sells exports at a lower price abroad than in the exporting country (as a result of having more market power at home), but above cost, this would be considered dumping. However, although import competitors may be hurt, the distortion that needs to be addressed is the higher price at the home of the exporter, and the lower price would be a net benefit to the importing country via an increase in consumer welfare.

Using the definition of dumping below cost, and defining cost to be average cost, it is clear that dumping can be a rational profit-maximizing, non-predatory behavior of a firm in the short run, as long as it covers its marginal cost during periods of slack demand. This type of dumping may also occur in a situation where the structure of costs is different for exporters and for domestic firms. For example, foreign exporters may view a larger proportion of their costs as fixed (e.g., Japanese viewing labor as a fixed cost, while the USA views it as variable cost), and in periods of diminished demand in the domestic economy, prices may fall quickly below the marginal costs of domestic firms, who will exit the industry, while remaining above the lower marginal cost of foreign exporters. So in this situation, exports displace domestic production, but only due to the higher fixed costs of exports.

There are also other reasons why firms may price below marginal cost as a part of an inter-temporal profit maximization. Slapping anti-dumping duties on these products provides domestic firms with protection, but it may be costly in terms of national and consumer welfare. The argument for anti-dumping duties is that firms may be using dumping in a predatory manner to eliminate competition and then raise the price once the competition is eliminated. This is a controversial issue. To be successful it requires the existence of sunk costs and the expectation by potential entrants that the same behavior by the dumping firm will occur were they to enter the market. Also, dumping and subsidies, from the exporter point of view, can be justified if the firm or home country derives significant externalities in the production of the goods or if there are scale effects. The latter can justify pricing below the average domestic price, since in that case, marginal cost are lower than average costs.

Another explanation for pricing below marginal cost may be that the firm's objective is not profit maximization, but sales maximization and the expansion of market share. In the

former case, it is argued that managers of firms are not primarily maximizing shareholder profits since they are rewarded according to the growth rate of the firm (i.e., size of operation/sales maximization). The excess output depresses price, harming competitors and expanding consumer surplus. Similarly, the firm's objective may be to capture market share by reducing prices as in the case of 'experience goods.' A producer will sell to its export market at a dumped price while its product is new and unfamiliar to the market, and then will raise price once a preference for it has been developed.

Anti-dumping duties, however, may not be the first best response to such a situation. The importing country could gain from the cheaper imports if it could credibly threaten to tax imports only after they become monopolized, thereby taxing away the monopoly profits which were the initial lure for the predatory behavior. Also, competition policy, when properly enforced could very well substitute for anti-dumping measures. Both predation and abuse of dominant position are sanctioned behavior under standard competition policy legislation. Applying extraterritorial jurisdiction, and this appear to be the trend, to competition policies would cover non-competitive pricing/behavior by foreign firms.

### *Ambiguity in Determining the Duty*

First determining what is 'normal' leaves much room for interpretation and in attempting to determine prices of sales in the domestic market of the foreign producer, sales to related companies and so on have been excluded. Originally, sales below cost in the exporting market were excluded in determining price, but more recently they have been included. In some cases there may be no, or an inadequate (deemed to be less than 5% in the USA and the EC), amount of domestic sales. In such a case there are two options which perpetuate further ambiguity-one of which is obtaining a comparable price of a 'like' product when exported to a third market. This leads to different interpretations of 'like' products, ranging from physical similarity to functional similarity. The other option is to determine the costs of production plus 'reasonable' administrative and selling costs plus profits. This again leaves room for much discretion in determining the duty. Similarly, there exists much subjectivity in determining injury and attributing causation to dumping.

### *Impact of Dumping Practices*

There is a widespread belief that unfair trade practices, including sales of goods at less than fair value (dumping), and subsidization of industry by foreign governments, injure domestic industries, drive firms out of business, and create unemployment. This belief has rallied the private sector and governments to amend their laws against dumping and subsidized imports, facilitating the relief of injured firms. Despite this passionately held belief it is interesting that little effort has been placed on evaluating the consequences of such actions. The central premise, that unfairly traded imports have been a serious problem, has remained largely unexamined. There is a recent analysis (Morkre and Kelly, 1994), of the effects of those actions on US domestic industries from 1980-88, between two important changes in the law: the Trade Act of 1979, which implemented the agreements reached in the Tokyo Round and the Trade Act of 1988. The Trade Act of 1979 introduced an injury test for most subsidized imports (previously, only duty free imports were given an injury test)

and made substantial changes in procedures for the administration of the law, inter alia, strict time limits for the various phases, and instructed the President to submit a reorganization plan to improve enforcement of the unfair import laws. The question posed in that study was not if there was injury, but rather the magnitude of the injury.

The US International Trade Commission made decisions on 221 cases. There was very good information on 179 of those cases to make an assessment of the magnitude of the injury. Of those 179 cases, only 53, or less than one third, induced a loss in domestic revenues as the result of unfairly traded imports that could be greater than 5%. Of those, only 21 cases involved a loss in revenue that could be greater than 10%. Moreover, the study went to great lengths to overstate the cases in favor of injury. Therefore, the reported injury levels are an upper bound. Industries are diverse, from agriculture and consumer goods to raw materials and industrial products and in the analysis, the benefits consumer derived from purchasing at lower prices was not considered.

Another undesirable by-product of anti-dumping measures is its potential use as a collusion instrument. The EC experience shows that anti-dumping actions have come to be used as a means of price collusion. Often domestic prices have stabilized after a decrease and foreign ones have increased. So clearly there are tradeoffs. Obviously, the elimination of anti-dumping measures could induce a more competitive domestic market, at the risk, however small, of the potential long term consequences of predation.

When a country applies anti-dumping duties on a particular product originating from a particular country, it may lead to 'country hopping' and 'product shifting' in an attempt to avoid the duties. The offending country may move production to the jurisdiction which imposed the anti-dumping duty or to a third country. They may also produce a slightly differentiated product to escape the duty.

Different countries have different approaches and interpretations of GATT articles, such as the definition of "like" products discussed above. There are also different levels of discretion allowed in different countries. The US system is considered most mechanical. Duties are automatically imposed equal to the calculated dumping margin, whereas other systems may confidentially indicate minimum prices under which duties would be imposed.

### **Issues in Countervailing Measures**

Similar to anti-dumping duties, countervailing measures are undertaken to offset adverse effects of a foreign country's trade policies on domestic industry, and deter foreign governments from intervening with targeted subsidy policies in the first place (reverse foreign aid). As stated in GATT Article VI:3, 'these duties are for the purpose of offsetting any bounty or subsidy bestowed, directly or indirectly, upon the manufacture, production, or export of any merchandise' on the part of the foreign government. GATT differentiates subsidies in research and development between applied and basic research. However, it is often difficult to differentiate between these two types. Since subsidies that increase exports tend to shift profits away from rival unsubsidized firms, other producing nations consider this unfair behavior. The countervailing duty provisions in GATT were developed to address

these concerns, and GATT rules allow (once a material injury test confirms the harm to domestic industry) a maximum duty limited by the total subsidy amount or payment that is embodied in the imports of the country setting the duty (an equal payment tariff). An equal export tariff offsets the effect of a foreign subsidy on the marginal costs of the subsidized firm, maintaining the level of exports to the country imposing the duty.

### *Determining the Extent of the Subsidy*

Although a subsidy is beneficial for the recipient industry, generally given perfect competition it is not so for national welfare. However, a national gain is possible when domestic oligopolists compete with their foreign counterparts in a third country. (Brander-Spencer, 1985)

In order to prevent profit-shifting from the domestic industry to the foreign industry receiving the subsidy, countervailing duties are imposed. However, GATT provisions fail to specify a method by which the total subsidy payment should be calculated, leaving a wide latitude in which to determine the value of the subsidy. For example, to calculate the subsidy value of a government loan to industry, US authorities use the commercial interest rates that firms would have otherwise had to pay to obtain that loan, whereas in the EC the interest rate that is used is the one at which the government borrows.

### *Importance of the Type of Subsidy*

The appropriateness of countervailing duties depends on the type of subsidy issued by the foreign government. Since export subsidies to non-primary products have been banned in the original GATT provisions (1948), an analysis of different types of capital subsidies is more useful. If the government provides interest-rate subsidies and these loans are designated to pay off existing debt, then little or no countervailing action is required, and an equal payment tariff would probably reduce exports and profits of subsidized firms below their pre-subsidy levels.

However, interest rate subsidies to existing capital (given imperfect capital markets), and subsidies specified for additional capital only tend to reduce the marginal cost of the firm, expand output and cause harm to foreign producers. In the former case, a countervailing equal payment tariff will be more than sufficient to prevent harm to industries in the importing country, but with respect to the latter case, an equal payment tariff may even be insufficient to prevent harm to rival firms in the importing country. This result depends on the size of the interest rate subsidy relative to the market rate of interest, the elasticity of substitution between capital and labor, and the extent of scale economies.

In responding to research and development subsidies, countervailing duties are unlikely to be helpful because by the time the subsidized firm is at the production (and export) phase, the foreign rivals have already been harmed and any duty would mainly hurt the importing country through higher consumer prices. More direct research and development subsidies aimed at cutting marginal costs of production may act more like subsidies to additional capital, in which case an equal payment tariff would be appropriate.

Similarly, the appropriate actions regarding grants and equity infusions also depend on the nature of their specification.

### **Safeguard Measures**

Safeguards refer to government actions responding to imports which are said to harm the import country's economy or domestic competing industries. Thus safeguards refer to import restraining means whether they be increased tariffs, quantitative restrictions, or "voluntary restraints" by the exporting country, or similar measures. The concept also embraces the "escape clause." The economic argument for safeguards is that an increase in imports could cause harm to selected groups within the importing country. Competing industries would have to adjust to the imports, either by improving their competitiveness or by moving resources away from that industry to some other industry. Consequently, a temporary period of adjustment is deemed to be necessary. The other argument for safeguards is more political. Because producers are better placed to seek and get protection of a permanent nature by providing a temporary measure it is felt that a more permanent increase in protection could be avoided.

The most significant mechanism of the international trading system is the escape clause under GATT Article XIX. For the clause to be put into effect it must be shown that imports are increasing absolutely or relatively and this is the causal result of unforeseen circumstances. It must also be shown that domestic producers are seriously injured or threatened with serious injury and that this injury has been caused by the increased imports. In these circumstances, the importing country is entitled to suspend GATT obligations in respect of the product for such time as necessary to prevent or remedy the injury. The importing country should consult with the parties that are major exporters of the product to reach an agreement on the means the injury could be avoided. If such an agreement cannot be reached, the exporters have the right to suspend equivalent concessions in response to restrictions imposed by the injured party.

As can be noted, many of the problems associated with anti-dumping are also present in the safeguard measure. They relate to definitions of unforeseen circumstance, serious injury and the fact that industries can be injured by many other causes other than the imports.

The safeguard mechanism, however, is better for competition than anti-dumping. If it could be made strictly temporary, fully transparent, non-discriminatory and could be granted following a thorough review of where domestic adjustment efforts could be undertaken during the lifetime of the safeguard. A safeguard mechanism would have the advantage of concentrating on the domestic industry, rather than finding fault with foreign business practices. However, and not surprisingly, industries prefer to go the anti-dumping route rather than safeguards. There are several reasons for this. First, the industry must admit that it cannot compete to invoke the safeguard provision. Second, restrictions arising from safeguards have to be imposed on a most favored nation basis. Third, the importing country must pay compensation to countries whose imports are restricted. Finally, the restrictions

must be reduced progressively. These reasons make safeguards less popular with industries, even though from a liberal trade policy viewpoint safeguards are superior to anti-dumping.

### **Risks and Consequences of Anti-dumping, Countervailing, and Safeguard Measures**

The proliferation of the use of anti-dumping and countervailing measures, as against safeguard measures, have led to fears that they may be used as a mere protectionist tool and the GATT has proved to be ineffective in disciplining the use and abuse of anti-dumping actions.<sup>6</sup> The reason lies in the excessively broad GATT rules and the excessive discretion and judgement provided on the part of those administering national laws, so that few actions would qualify as GATT 'violations.' Political economy issues are important since there may be room for political manipulation (be it direct or through lobbying) in the findings of dumping and/or injury (from dumping and foreign subsidies). There also appears to be an inherent bias in the system in favor of the domestic complainants, and to some extent, this has been attributed to a 'ratcheting effect.' This refers to a situation where incremental technical changes in the national laws tend to favor protectionist interests and enhance the likelihood of finding dumping and/or injury, unless trading partners are also willing to be more liberal.

Caution is also necessary in imposing these duties since a duty perceived as unfair is likely to result in further retaliation, leading to an escalation of tariffs and other protectionist measures in both countries, thereby worsening the situation. It is important to respond to 'unfair' trade practices of trading partners, but too wide a class of cases may lead to further protection. Some governments, for example, respond only to targeted subsidies of trading partner governments, and do not react to untargeted subsidies.

Also, all of the mentioned trade policy efforts provide temporary relief from import competition for the affected industries, but weaken growth and efficiency prospects for the post-recovery phase. Moreover, resources are likely to be diverted to rent-seeking, slowing restructuring efforts which would render industries fit as future exporters. Reduced competition in product market, furthermore, tends to increase both price pressures and wage pressures with negative implications for the competitiveness of other sectors and for employment.

In spite of potentially large legal costs, anti-dumping laws and countervailing duties are important and may be considered the international dimension to national competition policy. It has also been argued that it serves the purpose of an 'interface mechanism' which facilitates trade among very different economic entities.

Finally, an argument can be made for the replacement of anti-trust laws/policy with trade laws/policy. As integration and globalization furthers the irrelevance of borders the need for trade measures becomes less clear. In that context, a harmonized anti-trust legislation might suffice to deter anti-competitive behavior.

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<sup>6</sup> During the 1989-94 period, only 15 anti-dumping actions have been the subject of GATT dispute settlement. Of these, five anti-dumping actions have been found to be in violation of GATT rules, but none has been removed.



With the trade liberalizations in Latin America there has been a clamor by domestic industries to adopt anti-dumping, countervailing, and safeguard provisions. These are now being adopted. There is the fear, however, that these provisions could turn into to protectionist devices that would stifle competition. It is a common experience in the case of the trade liberalization in the industrial countries that with reduced tariffs, a new type of protection arises. It is sometimes called process protection. As tariffs have dropped, the number of anti-dumping and countervailing cases have significantly increased. For example, the amount of countervailing actions has increased five fold in the United States since the 1970s. Likewise, for anti-dumping cases between NAFTA countries. Other approaches to limit trade and competition also increased such as the VERs. Some have argued that the introduction of these so-called grey area projections was the result of an inadequate safeguard mechanisms. In this regard, the exiting GATT law has been faulted. The new laws are not very much better. These rules, designed during the Uruguay Round, are vague enough to give individual countries enough latitude to use them for protectionist purposes. There are two factors that will militate against the use of these measures as protectionists devices. First is the strengthening of the dispute settlement mechanism under the WTO. Second is the attempt to make the safeguard mechanism more attractive compared to anti-dumping. Finally, the conviction of countries to use trade instruments to increase competition and eschew protection is the best guard against use of these trade measures as protectionist devices.

Few countries have applied anti-dumping with great restraint and a high degree of professionalism. Anti-dumping and other similar provisions are often politically necessary to keep the "opening" process working, since the government could say that it would tackle unfair competition through this means. The Colombian government has adopted a safeguard going beyond GATT, Article XIX. It has the proper approach in terms of maintaining competition. First, the Colombian safeguard measure requires that the injury be real rather than threatened. Second, the time period given as relief is one year rather than four years in the GATT article.

On countervailing duties the situation is less sanguine. They are less resorted to than anti-dumping. The proof of a government subsidy is more difficult to establish, given that there are more indirect subsidies. Moreover, there are special problems associated with the measurement of subsidies particularly in socialist countries where market prices are not well established. Hence, the problems with the exports from China and the countries of the former Soviet Union. However, preventing a greater recourse to the use of countervailing measures is the increased sanction given to the subsidy codes, which had been adopted in the Tokyo Round but not put into wide practice. Following the Uruguay Round there are better definitions and a more effective mechanism, including the dispute settlement mechanism, that will reduce the prospects of using countervailing actions at the source of the subsidization. Finally, the extra-territorial application of competition law, often implemented on the basis of unilateral judgements, is another source of tension that must be addressed, preferably through treaties and harmonization of enforcement efforts.

While the above issues and challenges have arisen with respect to the use of the trade measures that have the potential to limit domestic competition, traditional trade reforms have progressed well in the world since the 1970s. This is best seen in Latin America. In this

sense the traditional protectionist devices have been subdued but the new protectionist measures as contained in the anti-dumping, countervailing, and safeguards pose more of a threat in the future. The Uruguay Round had been singularly successful in limiting the scope for protection via tariffs and quantitative restrictions and subsidies to exports. This gives hope that the remaining agenda for promoting competition through the trade measure is in the administrative or process protection practiced by the industrial countries since the 1970s.

## **5. *The Results of Trade Reforms and Competition Policies in Latin America***

What evidence is available as to the results of trade reforms supports the view that they have been beneficial in terms of improving allocative efficiency, increasing exports, and leading to higher overall growth. There are a number of studies that confirm the beneficial effects of trade liberalizations on efficiency and growth. These are the efficiencies gained through competition and overcoming of the limitations of the domestic market, the need to adjust exchange rates and adopt less distortionary policies under more open trade regime, and the creation of X-efficiency due to import competition.

Statistical support for the beneficial effects of trade reforms on economic development is found in a number of studies. Over fifty such studies are cited by Edwards, (1993); and Levine and Renelt, (1991). Using the new growth theory approach where policy can affect the rate of growth (the neo-classical models do not allow for this) Krueger and Osmond (1990) find that distortions on the trade and payment regime are negatively correlated with growth rates.

Trade reforms in a sample of sixteen Latin American and Caribbean countries led to import growth in ten cases. In the other six, there was low import demand given the strong fiscal adjustment that accompanied the reforms and sharp increases in relative price of imports given the large devaluations. (Alam and Rajapatirana, 1993) One can surmise that the increase in imports did increase competition in the import substituting sector. In some cases, while import liberalization did not lead to an immediate increase in imports and therefore did not increase competition, there were import surges in a year or two. This is the case of Colombia. Following the acceleration of import liberalization in 1992 there was only a small increase in imports. But eighteen months later, imports increased by some fifty percent. The other piece of evidence for increased competition following import liberalization is the increase in demands for protection in the sectors that were more affected by the imports or where competition had increased strongly. This is the case in Colombia with textiles and garments, as well as agriculture, some industrial products in Argentina and footwear in Venezuela.

Recent re-interpretation of the East Asian countries' success with exports and income growth has identified the discipline derived from competition as a powerful factor. All the Asian countries, except Hong Kong, went through an import substitution phase. These countries established a near free trade regime for exports and subjected exports to export rivalry. They did liberalize their import regimes over time and presumably increased foreign competition for their import substituting industries. While this exactly the sequence was the cause of their success cannot be adequately known because of the difficulty of finding a counterfactual. However, Hong Kong did face import competition from the beginning and

Thailand, Indonesia, and Malaysia experienced increases in efficiency when their import regimes were liberalized. (World Bank, 1994)

Regarding competition policies, there is much still to be accomplished in Latin America. Only six countries have enacted comprehensive anti-trust legislation, Chile, Venezuela, Peru, Mexico, Colombia, and Jamaica. And most of this legislation has been enacted only within the last two years. Therefore, there is little record to evaluate. Yet, some of the positive results of competition policies in Latin America are already apparent. In Venezuela it has had a significant impact in breaking and deterring existing price agreements among competitors. In Chile a main focus has been the successful breaking of vertical restraints, while Mexico has focused on merger policy and in more the former than the latter breaking collusive practices. Peru has successfully facilitated entry and exit in economic activity and deterred distributional restraints and misleading informational practices. Common issues in all these countries are scarcity of resources and little experience to properly enforce the legislation (Guasch, 1994).

## **6. *The Case for Harmonization***

As the process of globalization and deep integration continues throughout the region via adherence to GATT or the forming and extension of trading blocks or through unilateral free trade policies, the issue of harmonization of laws, regulations, and policies, across countries looms larger. Different regulatory, legal or even governance systems affect market access and market presence, and hamper integration initiatives. Moreover, the positive interplay between trade and competition policies is facilitated and enhanced with harmonization of laws, regulations, and policies.

The virtues and rationale of integrated countries and harmonized systems are clear. They maximize global economic efficiency, and minimize transaction costs-both public and private - and uncertainty. Heterogeneous laws, regulations, and enforcement provide for unfair competitive advantages, restrain trade, and hamper realization of the potential benefits of open trade policies. In establishing compatibilities, harmonization expands markets and increases access and opportunities, eliminates unfair trade advantages, increases transparency, and facilitates competition. The magnitude of the potential benefits from different levels of integration are thus considerable.

There are also costs. Harmonization hampers experimentation, imposes loss of sovereignty, breaches cultural and objective differences. It involves high set up costs and there are costs in resolving differences in objectives and of selecting salient\consensus modes.

The harmonization process must: i) deal with divergences in both substance and enforcement and with the choice of focus between principles, practices or a mix; ii) recognize that different enforcement levels of harmonized legislation affects adversely trade and competition; iii) establish priorities on what should be harmonized as well as desirable and minimal levels of harmonization; iv) be imbedded in treaties; v) recognize the need for the establishment of a binding supranational body to enforce compliance and resolve disputes, so as to harmonize enforcement; vi) understand when and how mutual recognition practices

should be adopted within a harmonization initiative; vii) recognize that some harmonization can be induced through competitive or market pressures; and viii) clarify if and when exemptions or stricter norms should be allowed so as not to excessively weaken harmonization.

Substantive convergence or harmonization must first confront the fact that the overall objectives may vary from country to country as well as initial conditions. Objectives other than efficiency are often included by many countries, but these social and political objectives vary across countries and may often conflict with the target of economic efficiency. As the EC experience illustrates, the root cause appears to be the substantial differences in country approach to regulation and policies stemming from deeply-held national convictions about the dividing-line between market forces and government intervention.<sup>7</sup>

In consequence, any harmonization initiative would have to accept that important differences in substantive laws will remain for the foreseeable future, because of differing policy goals, legal traditions, substantive transaction costs associated with changes or inertia. Also, when pursuing harmonization initiatives, there is the risk that in trying to reconcile different views and objectives, the resulting agreed upon harmonization will be excessively broad and vague and thus ineffective.

The constituencies for harmonization are multiple. There are multinational enterprises (MNEs) seeking to reduce transaction costs.<sup>8</sup> It is also in the interest of many home countries to reduce the risks of investment flight, since investment today is highly mobile and responds to best treatment and harmonization can reduce the risk of relocations. Finally, another constituency is the multilateral organization in their quest to promote global efficiency.

To illustrate the relevance of harmonization and its potential impact, it might suffice to consider one aspect of the legislation—domestic competition policies. This is a critical area for all trading nations. The last several years have seen a sharp rise in the frictions arising from the interplay of domestic competition policies in the areas of merger reviews, in the arrangement between buyers and suppliers in domestic markets and in the use of domestic laws in foreign jurisdictions. For example, merger policy differs across countries. A merger today can involve operations spanning a host of countries thus involving applications to competition authorities in many jurisdictions at the regional, national, and subnational level. An example of this is Siemens and GEC referring their bid for Plessey separately to the British, German, French, and Italian governments, and in addition, to the European Commission. A recent US merger case, required 17 different filings, since the case impacted 17 different jurisdictions.

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<sup>7</sup>This echoes the conflict between the US and Japan on the role of product liability versus detailed regulation specification.

<sup>8</sup> To provide an indication of the extent of that constituency, it suffices to mention that by the 1990's MNEs accounted for over 80% of US trade. Equally important, worldwide sales of foreign affiliates of all countries were nearly twice the value of world exports of goods and services underlying the fact that investment as well as trade is an essential route of access to foreign markets.

Conflicts between domestic competition policies and interlinkages with trade policy will keep increasing as multinationals expand through foreign direct investment, and as transnational mergers, joint-ventures, production and research consortia also increase in frequency. These cross-border ventures and the existence of differing competition laws across countries will exacerbate competition and trade disputes. The evidence already is the increasingly anti-trust-related trade disputes and trade-related anti-trust disputes, particularly between Japan, the US and the EC. Different environmental and consumer protection laws are another source of conflict and tension in harmonization initiatives and tend to affect adversely the interplay between trade policies and competition policies.

Similar issues and frictions appear on harmonization of the regulatory environment, the setting of standards, of foreign investment and ownership laws, of labor and benefits laws, of the intellectual property laws, of the tax structure, industrial policies, etc.

Finally, as important is the harmonization of enforcement and of resolution of disputes. Without it, effective harmonization will not result. This requires supranational institutions and dispute resolution mechanisms with binding resolutions. The apparent trend toward the use of extraterritorial jurisdiction is not a fully satisfactory mechanism and can lead to contradictions.

## **7. Conclusions**

As a result of the far reaching trade reforms undertaken in the 1980s and the 1990s, Latin American and Caribbean economies are among the most open in the developing world. Significant reforms have also taken place in the area of foreign investment legislation to allow foreign firms market presence, although some selective areas have been left protected. However, reforms in competition policy legislation and particularly its appropriate enforcement are yet to be addressed in most Latin American countries. The increased globalization of the economies requires a comprehensive and integrated approach to those policies with tendencies toward harmonization of both policies and enforcement. The complementarities are clear, and so too are the opportunities for tension between trade and competition policies. The latter are rooted on the historical antecedents of these policies, the short term vision induced by political cycles, tempting opportunistic responses to economic downturns, timing differences between accrued benefits and costs, and that even within the existing GATT law several anti-competitive trade policies are permitted. Thus for example, the so-called grey areas of protection, VERs, anti-dumping, and countervailing actions can be controverted to reduce the force of international competition. The pressure to revert to the use of those instruments as protectionism devices is ever present and the evidence of those practices is already ample. Trade policy may have to yield to the macroeconomic exigencies that arise. For example, today in Latin America there are examples of exchange rate appreciations arising from capital inflows that have led to pressure on the trade regime for some reversals, even though open trade as a principle has taken root in the continent. Argentina, Colombia, and Uruguay have shown certain departures from the earlier regimes in the form of increases in some barriers. Colombia has introduced reference prices for textiles and garments, as well as for eight agricultural goods. In this sense, both trade and competition policies are dependant on the macroeconomic environment.

Similar evidence, as previously reported, is a cause for concern and exists in the possibility of anti-dumping, countervailing, and safeguard measures turning into protectionist measures and limiting competition as a result. Mexico and Brazil have been the most active in Latin America in the use of those instruments. The institutional design of the corresponding agencies is crucial to limit reversals and rent-seeking opportunities. Colombia, Argentina, and Trinidad and Tobago have recently adopted these laws, conforming along the lines of existing GATT principles. The institutional arrangements for implementing these policies would become highly relevant from a political economy point of view. For, if the institutions that administer these measures within a country are not carefully constituted, they could be captured by protectionist and anti-competitive interests. Therefore, adherence to GATT principles alone, does not always lead to competition. There is, therefore, the danger, that these measures could be the new methods for protection, imitating industrial country policies.

The emergence of trading blocs in Latin America and the new Andean Pact, as desirable as they are, have further raised some tensions. First, there have been recent departures from the most favored nation principle with the proliferation of regional integration arrangements. While they are permitted under article XXIV of the GATT, the provisions of the article have hardly even been followed. Jackson (1989) has remarked that the departure from that particular article have been rife. Even if the rules had been duly followed to the letter, there would still exist the need to harmonize the regulatory environments so as to enhance competition with the reduction in trade barriers within a trading bloc. Second, the potential and already evident in some cases, use of rules of origin as anti-competitive and protectionist devices.

Similarly, the lack of enthusiasm of many Latin American countries in adopting and embracing competition policies should be a source of concern. However, recent measures taken by a number of countries provides for some reassurance that the tide is turning and that most countries are becoming aware of the relevance of having integrated and complementary trade and competition policies, notwithstanding the pressures and temptations for reversals.

The current efforts should be directed toward the implementation of comprehensive competition policies and credible enforcement agencies. They should also be aimed toward the gradual phasing out of most of the trade policy instruments, such as anti-dumping, countervailing duties and safeguards and their replacement by a broader application of competition policies and of extraterritorial jurisdiction.<sup>9</sup> Competition policies, when broadly used can effectively substitute for most trade instruments. Restrictions on foreign investments and ownership should be fully eliminated. This should facilitate the capturing in the home country of a larger share of the benefits of trade liberalization. Moreover, efforts should continue toward the harmonization and enforcement of those policies across countries and toward the creation of binding supranational enforcement institutions.

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<sup>9</sup> An innovative and welcomed step in that direction is the institutional design of Peru's competition enforcement agency, INDECOPY. It has been given jurisdiction to enforce both trade and competition policies.

## Appendix A: Analytical Basis of Complementarity between Trade and Competition Policies

In the standard neo-classical model of trade with two goods,  $(x_1, x_2)$  a small country assumption and community utility functions, four cases are possible for the interaction of trade and competition policy. These are: case 1, free trade with competition policy; case 2, free trade with no competition policy; case 3, restricted trade with competition policy; and case 4, restricted trade with no competition policy. Case 1, which gives the highest utility, is free trade combined with competition policy. This is seen in figure A which shows free trade with and without competition policy. The values for utility shown by  $U_1$  is superior to the other three possibilities. The case of free trade with no competition policy is shown with  $U_2$  which is case 2.

Figure A. Free Trade

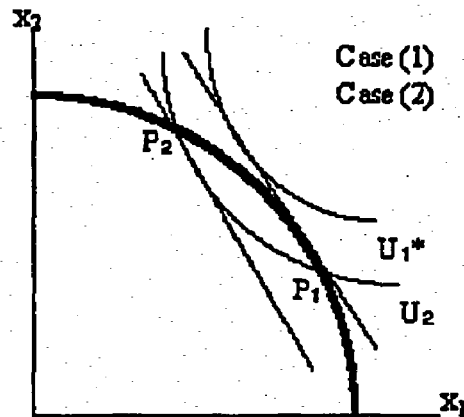


Figure B. Restricted Trade

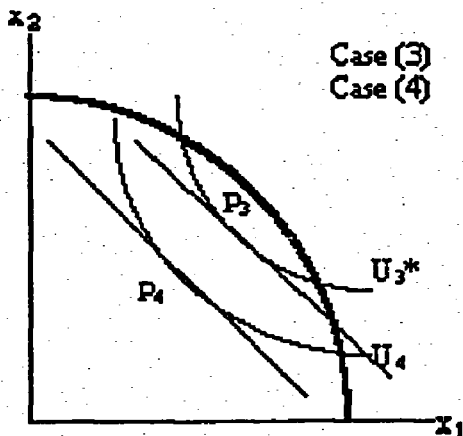


Figure B shows the two cases with restricted trade with and without competition policies. Case 3 is one that has restricted trade with competition policies. Case 4 is restricted trade with no competition policies.

Given the standard assumptions of this model it is possible to rank the order of combinations of trade and competition policies as  $1 > 2 > 3 > 4$ . When the assumptions do not hold, due to increasing returns to scale and the presence of externalities, this ranking could change in less predictable ways. In the first instance the ranking between 2 and 3 could lead to a reverse order. That is when protection is

pursued for strategic trade theory purposes. However, this situation is not viable in the presence of less than altruistic public officials who may be tempted to extract their own rents so that societal welfare is reduced.

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